United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-7278

To be argued by
MAXWELL E. COX

11-18

United States Court of Appeals

FOR THE SECOND CIRCUIT

B

MARGARET MARY McDONNELL MURPHY,
Plaintiff-Appellant,

P/S

—against—

McDONNELL & CO., INCORPORATED and THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, President,
Defendants,

JAMES F. McDONNELL, JR., individually, as Trustee under the Will of James F. McDonnell and as Executor of the Estate of Anna M. McDonnell, and CHARLES E. McDONNELL, as Executor of the Estate of Anna M. McDonnell,
Plaintiff-Appellants,

—against—

THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, THE NEW YORK STOCK EXCHANGE, INC., THE AMERICAN STOCK EXCHANGE by H. VERNON LEE, JR., Secretary, and McDONNELL & Co., INC.,
Defendants.

UNITED STATES COURT OF APPEALS
FILED
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SECOND CIRCUIT

REPLY BRIEF FOR PLAINTIFF-APPELLANTS MARGARET MARY McDONNELL MURPHY AND JAMES F. McDONNELL, JR. AND CHARLES E. McDONNELL, AS EXECUTORS AND TRUSTEES

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November 18, 1976.

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Preliminary Statement

There is no disagreement among the parties to this appeal as to the essential elements of a stock exchange's

liability under section 6 of the Securities Exchange Act of 1934 (the "Exchange Act").* Those elements, as charged by the court below (Vol. VIII; Tr. 2629), are:

1. Proof that the exchange knew or had reason to believe or suspect that its member was acting in violation of the rules of the exchange.

2. Proof that the exchange thereafter failed to take reasonable action.

3. Proof that such failure to act proximately resulted in damage to the plaintiffs.

Having so charged, the court below informed the jury that the defendant New York Stock Exchange (the "Exchange") had the power to make the requirements of the crucial net capital rule tougher or easier. (Vol. VIII; Tr. 2659) This charge short circuited the jury's consideration of the first, threshold element of section 6 liability—the existence of a violation—by telling it that McDonnell & Co.'s frequently astronomical net capital ratios might easily be *legal* exceptions and not *illegal* violations. The Exchange now contends that this rule 325 exception charge was both a correct statement of the rule and supported by substantial evidence. It was neither. (Point I *infra*)

Had the jury been permitted by a correct instruction to consider the reasonableness of the action taken by the Exchange with regard to the net capital violation by McDonnell & Co., the jury could only have concluded that such action was unreasonable. Accordingly, a reversal of the verdict below with a direction to enter judgment in favor of the plaintiffs on their claims under section 6 is required. (Point II *infra*)

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* 15 U.S.C. § 78f. All references to the Exchange Act herein are to the statute as in force during 1968, 1969 and 1970, prior to the amendments made by the Securities Reform Act of 1975.

Similarly, the court below erred in its refusal to instruct the jury that under certain circumstances "reasonable action" within the meaning of the second element of section 6 liability encompasses a duty of disclosure to potential investors. This error, which was compounded by the district court's withdrawal of the issue of the Exchange's liability under Rule 10b-5, in and of itself requires a reversal of the verdict below. (Point III *infra*)

With regard to the third element of section 6 liability, it is clear from the evidence below that the Exchange's failure to take reasonable action resulted in the plaintiffs' subordinated investments. The Exchange cannot avoid responsibility for the damage brought about by its failure to act reasonably by asserting that the plaintiffs lack standing under section 6. First, subordinated lenders are proper plaintiffs in a cause of action for breach of a stock exchange's regulatory obligations. Second, it is ludicrous to contend that an investor who is defrauded into sacrificing his public status as a result of the Exchange's failure to take proper action is simultaneously deprived of his standing to recover against the Exchange. Such a result would mean that the Exchange could avoid liability by violating its statutory obligations. (Point IV *infra*)

The American Stock Exchange (the "Amex") asserts that its sole section 6 obligation is to enforce compliance with its own rules, which delegated the financial supervision of McDonnell & Co. to the Exchange. The Amex's argument ignores the fact that its obligation under section 6 is to enforce not merely its own rules but the provisions of the Exchange Act and the rules of the Securities and Exchange Commission. Moreover, while under the Amex's rules, McDonnell & Co., as a dual Exchange-Amex member firm, was not required to file certain financial reports with the Amex, McDonnell & Co.'s status as a dual member firm did not exempt it from compliance with the provisions of the Amex's capital rules. The Amex failed to enforce its

net capital rules in the case of McDonnell & Co. and is liable for the resulting injury to the plaintiffs. (Point V *infra*)

I

The Rule 325 "Exception" Charge Was Improper.

It is reversible error for a court to instruct a jury as to abstract principles of law which are not supported by the evidence before it. See, *e.g.*, *Jackson* v. *Crockarell*, 475 F.2d 746, 748 (6th Cir. 1973). The Exchange does not dispute this principle, but rather, argues that the rule 325 "exception" charge was proper because there was substantial evidence from which the jury could conclude that such an exception had been made in the case of McDonnell & Co. The Exchange's argument distorts both the evidence and the issues before the jury. The charge was incorrect; it should not have been given; and a reversal is required.

The principal factual issue to be decided by the jury below in assessing the liability of the Exchange was whether the Exchange properly discharged its supervisory and enforcement duties with respect to McDonnell & Co. at the time plaintiffs made their subordinated loans. In deciding this issue, the threshold question before the jury was whether McDonnell & Co., at the time of the investments, was in violation of the net capital rule and whether the Exchange had knowledge of, or reason to know of, that violation.* Without question, McDonnell & Co. in January 1969 was in violation of the net capital rule and the Exchange knew it.

On January 9, 1969, Thomas A. McKay, senior vice president of McDonnell & Co., telephoned Herbert Schuette of the Exchange's Department of Member Firms and informed him that the results of the firm's as yet unfiled regular financial questionnaire would show a net capital violation as of October 31, 1968 (Ex. 38). Four days later,

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* *Marbury Management, Inc.* v. *Alfred Kohn, Wood, Walker & Co.*, 373 F. Supp. 140, 143 (S.D.N.Y. 1974).

McKay informed Schuette that the firm would need an additional $1.7 million to bring its ratio to the 2000% level and $2.3 million to reach the 1500% safe mark (Ex. 37). During the course of these conversations, McKay indicated that the firm planned to raise the amounts needed by negotiating for further subordinated funds (Ex. 38). A preliminary Exchange analysis of the still not formally submitted financial questionnaire showed net capital ratios of either 2717% or 3992% (Ex. 39). Both these figures violated rule 325. Both figures were known to the Exchange on January 28, 1969.

On January 29, 1969, with this knowledge, officials of the Exchange met with officials of McDonnell & Co. At that meeting the Exchange did not say, "we are making an exception to rule 325 in the case of McDonnell & Co." The Exchange did not say, "we are going to make the requirements easier in the case of McDonnell & Co." At that meeting the Exchange *ordered* McDonnell & Co. to raise additional capital and to raise it fast.

The court's charge on rule 325 robbed the jury of an opportunity to consider whether the Exchange failed to take reasonable action with respect to the net capital violations at McDonnell & Co. in January of 1969 by permitting the jury to conclude that such astronomical capital ratios as 5525%* could easily be permissible exceptions under rule 325.

The Exchange contends that the testimony of Robert Bishop concerning non-normal application of the rules from February 2, 1970 to March 13, 1970 provides a "substantial" basis for the court's erroneous charge on rule 325. Whether the Exchange made a non-normal application of the rules or even an exception to the rules in February and March of 1970 is totally irrelevant. The critical period was late 1968 and early 1969. By February 1970, McDonnell & Co., once a leading broker-dealer, was, as a result of the

* See Ex. 28.

Exchange's total disregard of its statutory obligations, irretrievably lost. Indeed, the "non-normal application" referred to by Bishop was not a decision to make the net capital requirements easier or tougher but to quietly deliver out all McDonnell & Co. customer accounts before publicly shutting the firm down.

By February of 1970 McDonnell & Co. was a lost cause. It was lost because the Exchange failed to take appropriate action in late 1968 and early 1969 to correct the firm's earlier net capital violations. The court's charge allowed the jury to view those earlier violations as permissible exceptions in the face of a record devoid of any evidence that any exception had been made and a congressional mandate prohibiting the making of such an exception.* Over objection this clearly erroneous charge was repeated moments before the jury retired to consider its verdict. (Vol. VIII; Tr. 2659)

II

The Exchange is Liable to the Plaintiffs as a Matter of Law for Its Failure to Take Reasonable Action.

The trial court's charge effectively removed from the jury the threshold issue of whether the Exchange knew of a violation of its net capital rule. Absent the improper instructions that the Exchange could make the requirement

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* As set forth in Point I of plaintiffs' principal brief, under the provisions of section 8(b) of the Exchange Act (15 U.S.C. § 78h (b)), Congress mandated that "It shall be unlawful for any member of a national securities exchange, . . . (b) to permit *in the ordinary course of business as a broker,* aggregate indebtedness . . . to exceed such percentage of the net capital . . . employed in the business, but not exceeding in any case 2000%, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors." (Emphasis added.)

The Exchange's argument concerning brokers versus broker-dealers is specious. Rule 325 itself is, like section 8(b), directed to capital requirements of a member "*. . . in the ordinary course of business as a broker. . . .*"

tougher or easier, the jury could only have concluded that the Exchange knew that McDonnell & Co. as of October 31, 1968 was in violation of its net capital rule. Indeed, the Exchange's brief concedes this much.

Given the violation, the question became whether the Exchange's response was reasonable. The jury never had to reach this question. Had it done so, under the evidence it would have had to return a verdict for the plaintiffs.

Sending McDonnell & Co. out into the world to raise $500,000 within 48 hours was, as a matter of law, inadequate and unreasonable regulation. First, the Exchange issued its orders without pausing to make an accurate assessment of the depth of McDonnell & Co.'s net capital violation. As a result, the Exchange presented the firm with a dollar quota which, if reached, would not even bring McDonnell & Co. into net capital compliance. Second, the Exchange's plan to cure McDonnell & Co. with large doses of new dollars did nothing to clear up the firm's underlying record-keeping violations, which were the basic source of its capital problems.

A. As to the Net Capital Violation

The evidence established that McDonnell & Co. remained in violation of the Exchange's net capital requirements even after Mrs. Murphy and Mrs. McDonnell had invested almost $1.5 million in securities in the firm. The Exchange does not question this fact. Indeed, it could not do so. The Exchange's own analyses show that even taking into account the plaintiffs' subordinated investments, McDonnell & Co.'s net capital deficiency as of January 30, 1969 exceeded the firm's deficiency as of October 31, 1968 by at least $1,725,875. (Ex. 28) The Exchange claims that it did not know that the plaintiffs' investments would not be sufficient to cure McDonnell & Co's net capital violation until long after those investments had been made. This claim, in and of itself, is a shocking admission of the inadequacy of the Exchange's regulatory response to McDon-

nell & Co.'s capital problems. For the Exchange to have turned McDonnell & Co. loose to solicit new investments without knowing whether those investments would place the firm on a financially sound footing was a grossly irresponsible act.

Moreover, the evidence established that the Exchange did, in fact, know that plaintiffs' investments would be insufficient. In a January 28, 1969 letter, McDonnell & Co. advised the Exchange that as of December 30, 1968, $3,084,000 would be required to bring the firm into compliance with the 2000% requirement and $4,647,000 would be necessary to bring the ratio down to the 1500%, considered necessary to a sound operation.* The Exchange's so-called regulatory response simply ignored the information contained in that letter. No matter what degree of discretion the Exchange may have in enforcing its rules, it abused its discretion when it failed to take into account all available information concerning net capital problems at McDonnell & Co. before it acted.

Moreover, even if the Exchange's actions are viewed solely as an attempt to cure McDonnell & Co.'s net capital deficiencies "as of October 31, 1968," without regard to later developments known to the Exchange, those actions were still unreasonable and inadequate. A "minimum improvement of $500,000" by the close of business on January

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* Ex. BB(1). The figures quoted in the letter for December 30, 1968 take into account the additional $845,000 "to be available." The Exchange characterizes this additional capital to be available as a fact from which the Exchange could infer that McDonnell & Co. had improved its capital position since the audit date (Exchange Brief at 12). This "improvement" was more than offset by other adverse changes in McDonnell & Co.'s net capital position between October 31 and December 31, 1968, which are not mentioned in the Exchange's brief. Furthermore, even taking into account the asserted improvement in McDonnell & Co.'s capital position between December 31, 1968 and January 28, 1969, claimed on page 3 of the letter, McDonnell & Co. would have needed at least $1,800,000 to reach the permissible 2000% level and at least $3,350,000 to reach the safe 1500% level.

31, 1969 would not have brought McDonnell & Co.'s capital ratio "within the required 2000 percent by the end of that week" as now stated by the Exchange (Exchange Brief at 12). On the basis of the Exchange's own analysis of the October 31, 1968 figures, McDonnell & Co. would have needed a minimum of $1,510,780 to reach net capital compliance (Ex. 74).*

The "directive to comply immediately [with the net capital rule]—which was fulfilled by McDonnell" (Exchange Brief at 45) was, in fact, nothing of the sort. Neither the $500,000 mandated by the Exchange nor the funds actually supplied by the plaintiffs' subordinated loans were enough to do the job.**

Either the $500,000 was an arbitrary figure, not calculated to bring McDonnell & Co. into compliance, or it was the result of bad arithmetic. In either case, the response was not reasonable, for the Exchange had a duty to enforce its rule. Certainly, those who invest in a member firm that is short of capital are entitled to assume that once the in-

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* The minimum requirement set forth in the Exchange's February 7, 1969 letter to McDonnell & Co. is apparently based upon a capital ratio computed without making any charge against capital for short securities differences in excess of $1 million. *Compare* Ex. 74 *with* Ex. 28.

** The Exchange did not, as now suggested at page 15 of its brief, have any reliable information at that time that McDonnell & Co.'s capital ratio as of January 30, 1969 was a permissible 1886%. Exhibit 28, upon which the Exchange relies for this statement, is an April 24, 1969 Exchange examiner's report on McDonnell & Co.'s net capital condition. All the figures contained in that report are based on McDonnell & Co.'s financial questionnaire which was not formally submitted until February 28, 1969. A capital computation by David W. Rome, Controller of McDonnell & Co., indicated that the firm's ratio as of January 30, 1969 was 1886%. The Rome computation is *quoted* in Exhibit 28. Exhibit 28 also *reports* the Exchange's own computations of McDonnell & Co.'s capital ratio as of January 30, 1969: 2981%, 3825%, 3920% and 5525%. All these ratios violate rule 325.

vestment is made the firm will be in compliance with the rules of the Exchange and not subject to being shut down at any time.

One hesitates to suggest that the Exchange was so sloppy in its regulation of a member firm that it made a million dollar error in subtraction. Yet that is the only explanation on this record for the $500,000 requirement.

The Exchange's letter of February 7, 1969,* on which it relies to support the position that it enforced compliance with its net capital rule, shows the error. It states that the Exchange analyzed the October 31st figures to show aggregate indebtedness of $114,516,105 and net capital of $4,215,025. Since 1/20th of $114,516,105 is $5,725,805, the letter is correct in stating to McDonnell & Co. that "you were required to maintain minimum net capital of $5,725,805 under provisions of Rule 325. . . ." But the letter is plainly incorrect in stating that the Exchange's analysis "shows that you were $510,780 below requirement." The difference between $5,725,805 and $4,215,025 is $1,510,780, not $510,780.

The Exchange's regulatory response to McDonnell & Co.'s net capital violations was either the result of gross negligence or an inexcusable disregard of available data. In either event, it was scarcely "reasonable."

B. As to the Record-Keeping Violations

Even if plaintiffs' subordination of their accounts would have brought McDonnell & Co. into compliance with the net capital rule, even if the Exchange had not made a million dollar error in subtraction, the response would not have been reasonable, as a matter of law. The net capital violation reflected a deeper ill. To cure the net capital violation without doing anything about the record-keeping mess, which was also in violation of an Exchange rule, was

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* Ex. 74.

comparable to filling up a car's gas tank with a gaping hole in it as a cure for the car's running out of gasoline.

The Exchange contends that based on w[illegible]t knew, its response was reasonable. It was relying on the program of McDonnell & Co. to clean up the mess. It points to restrictions that it did impose, after the plaintiffs had made their investments, as showing that it acted reasonably. But what the Exchange did in April of 1969, which self-evidently did not solve the problem, is irrelevant to a determination of the reasonableness of the Exchange's action in January.

The application of the simplistic solution "more money" to a member firm's complex and multi-faceted operational problems was exactly the type of regulation found to be unreasonable by the Ninth Circuit in *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F.2d 156 (9th Cir. 1976), *cert. denied*, —— U.S. —— (Oct. 18, 1976). In *Dempsey-Tegeler*, as in this case, the Exchange had placed operating restrictions on the member firm in an attempt to solve its record-keeping problems and then lifted those restrictions. In *Dempsey-Tegeler*, as in this case, the Exchange sought to solve the member firm's financial problems by infusions of new capital without any corresponding reimposition of operating restrictions. In *Dempsey-Tegeler*, as in this case, the Exchange's quick-cure solution did not prevent the collapse of the member firm. The Ninth Circuit found that this pattern of regulation was a breach of the Exchange's section 6 duty and that the district court's holding to the contrary was clearly erroneous:

> ". . . Without the restrictions, the only response by the Exchange to the very serious problems of Dempsey was the addition of new capital. This failure of the Exchange to take constructive action toward the underlying problems of Dempsey constitutes a clear breach of its duty. If the Exchange determined that the lower level restrictions had not

> succeeded, it was obligated to suspend the firm. Instead, its attempted resolution so ignored the Exchange's duty owed to investors and potential investors in Dempsey that it far exceeds any permissible degree of discretion or flexibility in choosing a response. . . ." 534 F.2d at 174.

In the case of McDonnell & Co., the Exchange's action was unreasonable because the Exchange both disregarded known facts and failed to ascertain all the facts necessary to an informed decision. Even wide discretion does not justify proceeding in the absence of facts, let alone in disregard of them.

Here the Exchange acted first and investigated later. Once plaintiffs had made their investment, the Exchange sent its examiners into McDonnell & Co. to find out what was going on. On April 24, 1969, the examiners reported that, "there was no convincing evidence of improvement in operations or record keeping." (Ex. 25 at 4) Indeed, the state of the records was such that any capital computation prepared at that time would be questionable without a detailed audit. (*Id.* at 2) On receipt of this report, the Exchange imposed mandatory restrictions. But those restrictions did the plaintiffs no good because they came too late.

During the course of oral argument at the close of their direct case, plaintiffs contended, as they do now, that the Exchange's failure to impose appropriate operating restrictions on McDonnell & Co., prior to the time the subordinated investments were made, was inadequate regulation and had resulted in the loss of those investments. In response to that argument, the trial court stated, ". . . they [the Exchange] have to know what's going on in the company before they act. Otherwise, it is an irresponsible act." (Vol. V; Tr. 1656) What the trial court failed to perceive was that the Exchange did act. Either without knowing or without heeding what was going on in McDonnell & Co., the

Exchange ordered that more money be raised. The plaintiffs invested and lost over a million and a half dollars as a result of that irresponsible act.

III

The Exchange Had a Duty of Disclosure.

Plaintiffs do not contend on this appeal that Rule 10b-5 imposes upon the Exchange a strict vicarious liability for any and all fraudulent misrepresentations or omissions by a member firm; nor do plaintiffs contend that the Exchange's regulatory duties under section 6 obligate it to monitor every conversation between a broker-dealer and a potential investor—whether such conversation be between son and mother, brother and sister or total strangers. The plaintiffs do contend, and underlying principles of the Exchange Act require, that where, as in this case, the Exchange orders a firm to raise substantial sums of money, literally overnight, and where, as in this case, the Exchange is informed that its mandate for additional funds has been met by the solicitation of subordinated investments, the Exchange is obligated, both under section 6 and Rule 10b-5, to condition that investment on the disclosure to the investors of all material adverse facts in the Exchange's possession. The court below withdrew from the jury's consideration the issue of whether the facts of this case required disclosure by the Exchange and whether the Exchange fulfilled its duty of disclosure. That ruling by the court below requires a reversal of the judgment.

The degree to which a national securities exchange is obligated to make disclosure in circumstances similar to those in the present case was before the court in *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F.2d 156 *supra*. In *Dempsey-Tegeler*, the Ninth Circuit found that the Exchange had breached its obligations under section 6 by failing to make an appropriate regulatory response to a

member firm's record-keeping and capital violations. The *Dempsey-Tegeler* court, however, denied recovery to the injured investor on the grounds of waiver. The majority found that plaintiff Hughes was not only fully cognizant of Dempsey-Tegeler's financial and record-keeping problems before he made his investment but that Hughes himself had requested the Exchange to lift the operating restrictions, which it had previously placed on the firm in an attempt to solve those problems. In his dissent, Judge Trask rejected the waiver argument, primarily because in *Dempsey-Tegeler* the Exchange had made an inadequate disclosure and thus disregarded the most fundamental principle of the Exchange Act:

> "I would be more disposed to go along with the majority and resolve these doubts in favor of this Exchange had it been candid with Hughes. It just was not. It had a duty to be so. It rather attempted to get by with a partial and very minimal disclosure and insist upon Hughes signing a hold-harmless agreement to protect the Exchange against future liability. . . . This was not what Congress had in mind when it imposed upon the Securities and Exchange Commission a duty of regulation of exchanges and the Exchange imposed a duty of quality operation upon its members. It is the Exchange which must make the hard decisions. It has the facts and the expertise. If it chooses to risk half-way measures and encourage investments by half-informed investors, it should be held to shoulder the result if loss occurs." *Id.* at 185

On January 29, 1969, the Exchange knew several things about McDonnell & Co.: it knew that the firm's records were a total mess and that the record-keeping problems that had plagued the company for a period of over 12 months were not near a resolution; it knew that two of the firm's former partners were in the process of leaving and would take $400,000 in capital with them; it

knew that the firm had misrepresented its compliance with the net capital rule in order to secure repeated extensions of the filing date for its financial questionnaire; and it knew that McDonnell & Co.'s net capital ratio far exceeded the 2000% figure fixed to insure financial stability.

Paul K. McDonald, the expert troubleshooter who was recruited in an attempt to solve the firm's problems in July 1969, testified that he had been asked to make a subordinated loan to the firm in late 1968, at about the time the plaintiffs made their investments and that he refused to do so.

> "The subordinated loan agreement, in my judgment, surrenders substantially all rights of the lender to his money and subordinates it to a very high degree of risk.
>
> "I think that my comment at the time was that I may just as well walk over to the window and drop the money out." (Vol. VI; Tr. 1828)

The Exchange, with equal expertise and with more knowledge concerning the true state of affairs at McDonnell & Co. than conceivably could have been available to any potential investors, laid down a chapter-and-verse command:

> "$500,000 by 3 P.M. Friday January 31; $2,083,000 approximately one week thereafter; and either $300,000 or a corresponding reduction in $1,000,000 in outstanding shorts within one month. . . ." (Ex. 40)

Within hours, the Exchange was notified that the first installment of funds would be in by Friday, January 31, 1969, and that such funds would come from subordinated investments.* Was it reasonable, under these circumstances,

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* The Exchange had known for some time that McDonnell & Co. would rely heavily on plans to raise additional subordinated funds in an effort to solve its capital problems. (Exs. 37, 38) One of the prime sources of such funds was a subordinated loan by Manu-

for the Exchange to believe that full disclosure had been made, or should the Exchange have at least suspected that McDonnell & Co. had bent the truth in order to induce investments which were equivalent to dropping money out the window?

The role of the Exchange in events of January 29, 1969, was not one of inaction. The Exchange is not the passive accountant of *Ernst & Ernst* v. *Hochfelder** or *Wessel* v. *Buhler*.** The Exchange is not the uninformed director in *Lanza* v. *Drexel & Co.**** who did not initiate the acquisition in question. Here the Exchange was the prime mover of events, directing how much money be raised and how fast. The issue of whether the Exchange's participation in McDonnell & Co.'s fraudulent solicitation of the investments was sufficient to render it liable under Rule 10b-5 was an issue of fact. *Fischer* v. *The New York Stock Exchange*, 408 F. Supp. 745 (S.D.N.Y. 1976). The district

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facturers Hanover Trust Company and Mrs. Marjorie F. McDonnell (the wife of T. Murray McDonnell) as trustees of the so-called Flannigan Trust created by Marjorie Flannigan McDonnell's father. The loan by the trust, which the auditors counted as good capital in preparing their computations as of January 30, 1969, was subsequently rejected by the Exchange. (Exs. EE, EE(1)) The manner in which the Exchange discharged its regulatory responsibilities in the case of the Flannigan Trust is in sharp contrast with the Exchange's total failure to regulate in the case of the fraudulent exchange of the Series B debenture owned by the plaintiff McDonnell Trust. In the case of the McDonnell Trust, the Exchange made no investigation or inquiry whatsoever as to whether or not the investment was authorized. In the case of the Flannigan Trust, the Exchange, despite the fact that the lawyers for the Manufacturers Hanover Trust Company had approved the transaction as authorized, rejected the subordinated loan, because its own counsel expressed some doubts as to the trustees' authority to enter into the transaction.

* —— U.S. ——, 96 S. Ct. 1375 (1976).

** 437 F.2d 279 (9th Cir. 1971).

*** 479 F.2d 1277 (2d Cir. 1973).

court incorrectly withdrew that issue from the jury's consideration.

Similarly, the district court erred in its refusal to charge the jury that the Exchange's regulatory duty under section 6 encompasses a duty of disclosure. Section 6 is not, as contended by the Exchange, merely an enforcement statute. Separate and apart from the duty imposed upon the Exchange to enforce compliance with the Exchange Act by member firms is the section 6 stricture that the Exchange itself comply with the Act. The most fundamental provisions of the Exchange Act are the requirements of full disclosure. *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). Where the Exchange uses its section 6 enforcement powers to require a member firm to raise additional capital, it cannot simultaneously gainsay its section 6 compliance obligations.

The erroneous rulings of the district court with respect to the Exchange's duty of disclosure, both under Rule 10b-5 and under section 6, require reversal of the decision below with instructions to enter a verdict in favor of Mrs. Murphy and Mrs. McDonnell.*

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* The jury's verdict in favor of McDonnell & Co. as to the claims of Anna McDonnell does not, as the Exchange contends, constitute "law of the case" as to the liability of the Exchange on those claims. In the first instance, what the jury may or may not have found with respect to McDonnell & Co.'s fraudulent conduct *vis-a-vis* Anna McDonnell has nothing whatsoever to do with the Exchange's liability for failure to take appropriate regulatory action with respect to the net capital violations as required under section 6. Moreover, to the extent that that verdict may be relevant to the issue of fraud and the Exchange's liability under Rule 10b-5, it is clear that the so-called "law of the case" is based on a record replete with erroneous evidentiary rulings and the result of a trial in which all the plaintiffs, including Anna McDonnell, were denied substantial justice. (Plaintiff-appellants' Principal Brief at Point III)

IV

The Plaintiffs Have Standing to Maintain an Action for Damages Under Section 6 of the Exchange Act.

As a separate defense, the Exchange asserts that standing to maintain a private action for damages under section 6 of the Exchange Act is restricted to public investors and that, therefore, the plaintiff-appellants have no standing to maintain this action. In the first instance, it is clear that the status of the plaintiffs in this case was not merely that of subordinated lenders. Prior to January 29, 1969, the plaintiffs were public investors. Since their change in status to that of subordinated lender was itself the result of the Exchange's failure to properly discharge its regulatory responsibilities, the plaintiffs must have standing to recover damages resulting from that change of status.

Moreover, even as subordinated lenders, the plaintiffs have standing to sue because they are within the class for whose benefit section 6 was enacted and their maintenance of a private action under section 6 is consistent with the underlying purposes of the Exchange Act. *Cort* v. *Ash*, 422 U.S. 66 (1974).*

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* In *Cort,* the Supreme Court listed four factors to be examined in deciding whether, in the absence of express statutory language, a particular plaintiff has standing to assert a private remedy based upon the provisions of that statute.

> ". . . First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,' (emphasis supplied)—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?" (422 U.S. at 78) (citations omitted)

The propriety of a private remedy for breach of a national securities exchange's regulatory and supervisory obligations under

In *New York Stock Exchange* v. *Sloan,* 394 F. Supp. 1303 (S.D.N.Y. 1975) the district court carefully analyzed the precise issue of a subordinated lender's standing to maintain an action under section 6 and concluded that such an action is proper. *Accord Hughes* v. *Dempsey-Tegeler & Co., Inc.,* 534 F.2d at 165 n.4 *supra; Carr* v. *New York Stock Exchange, Inc.,* 414 F. Supp. 1292 (N.D. Cal. 1976); *Lank* v. *New York Stock Exchange,* 405 F. Supp. 1031 (S.D.N.Y. 1975), *appeal docketed,* No. 76-7243, 2d Cir. (1976); *Weinberger* v. *New York Stock Exchange,* 403 F. Supp. 1020 (S.D.N.Y. 1975). *Cf. Collins* v. *PBW Stock Exchange,* 408 F. Supp. 1344 (E.D. Pa. 1976).

The *Sloan* court recognized that the class that section 6 was intended to benefit was "investors" and that it would be illogical to artificially fragment that class into those who invest *through* a member firm, *i.e.,* customers, and those who invest *in* a member firm, *i.e.,* subordinated lenders. Holding that subordinated lenders have standing to assert a private remedy under section 6, the district court stated:

> ". . . No matter how their investment in the firm is characterized, they clearly have a large stake in the enforcement of the rules [of the Exchange]. Because their status requires them to rely on the general partners both to manage the enterprise and to comply with

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section 6 of the Exchange Act is no longer open to serious dispute. *E.g. Baird* v. *Franklin,* 141 F. 2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944); *Hughes* v. *Dempsey-Tegeler & Co., Inc.,* 534 F.2d 156 *supra, affirming* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,133 (C.D. Cal. 1973); *Weinberger* v. *New York Stock Exchange,* 335 F. Supp. 139 (S.D.N.Y. 1971). Similarly, the appropriateness of the federal district courts as the forum for the resolution of disputes based upon the federal securities laws cannot be questioned. Section 27 of the Exchange Act provides that "[t]he district courts of the United States . . . shall have exclusive jurisdiction . . . of all suits in equity and actions at law brought to enforce any liability or duty created by . . . [the Exchange Act] or the rules and regulations thereunder. . . ." 15 U.S.C. § 78aa.

the net capital and record-keeping rules, they are entitled to the Exchange's diligent enforcement of them. It follows that they may sue the Exchange for its failure to perform that duty." 394 F. Supp. at 1310.

Recognition of private actions by subordinated lenders is necessary not only to protect their rights as members of the beneficial class under section 6, but is also necessary to further the policy of self-policing by exchanges which is the underlying purpose of the Exchange Act.*

"It is reasonable to assume that prospective limited partners and subordinated lenders will be more inclined to invest in member firms if they can be confident that the Exchange is properly fulfilling its supervisory role. Investment in member firms is, of course, crucial to their liquidity and there is no question that a large group of viable member firms is the core concept of national securities exchanges. Cf. Gordon v. New York Stock Exchange, 498 F.2d 1303, 1305-1309 (2d Cir. 1974). Accordingly, to permit investors in member firms to sue the Exchange for failure to 'safeguard' their investment not only encourages such investment but promotes the overall purpose of the Act to provide an essentially self-regulating public market for securities investors. We further note that there is some evidence of the need for more effective supervision of the Exchange's performance of its duties under § 6. A congressional investigation of the state of the

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* The exclusion of subordinated lenders from the provisions of the Securities Investors Protection Act (15 U.S.C. § 78aaa *et seq.*, "SIPA") does not as suggested by the defendant Exchange evidence a congressional intent to deny subordinated lenders' standing under section 6. To the contrary, the provisions of SIPA serve to enlarge the role played by the non-customer investors in fulfilling the statutory scheme of the Exchange Act and to increase the necessity for continued recognition of their standing to enforce private remedies against the Exchange. *New York Stock Exchange v. Sloan,* 394 F. Supp. at 1313.

securities industry during the period 1967-70, when some 170 brokerage firms failed, concluded:

> 'The Subcommittee's hearings show concretely that the [New York Stock] Exchange's failings [to enforce its rules as to member firms] were one of the major causes of the operational and financial breakdowns which constituted the 1967-70 crisis in the securities business.' Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, Securities Industries Study, H.R.Rep.No. 92-1519, 92nd Cong. 2d Sess. VIII (1972).

"Specifically, the study noted that both the net capital rule 'and its enforcement proved sorely deficient when financial responsibility was tested,' and stated that there was 'grave doubt' about the Exchange's 'respect for its statutory obligations.' *Id.* at 93-94." 394 F. Supp. at 1314 n. 14.

Private actions by subordinated lenders, such as plaintiff-appellants, provide an important safeguard against an exchange's potential disregard of its statutory enforcement obligations. Clearly, the plaintiffs have standing to maintain an action under section 6 of the Exchange Act.

V

The District Court Should Not Have Directed Judgment in Favor of the Amex.

The rules of the Amex, like those of the Exchange, required that McDonnell & Co. maintain a ratio of aggregate indebtedness to net capital of no more than 2000%.*

* The net capital requirements of the Amex, comparable to Exchange rule 325, are contained in Amex rules 446, 466 and 467. The manner in which the Amex rules treat the requirement that a firm maintain a specific minimum dollar amount of net capital and the requirement that a firm not exceed a specific maximum per-

The evidence established that McDonnell & Co.'s net capital continually exceeded this limitation throughout 1968 and 1969. The evidence further established that on January 16, 1969, the Amex was directly notified by McDonnell & Co. that its annual audit would reveal a net capital violation as of October 31, 1968. (Ex. 91) It is undisputed that the Amex's regulatory response to notice of this violation was complete inaction.

The Amex asserts that under its rules the supervision of the financial condition of dual Exchange-Amex member firms is to be performed exclusively by the Exchange. In support of this contention the Amex cites five of its rules,* each of which deals with required financial reports by member firms and each of which provides that a dual Exchange-Amex firm, required to make financial reports to the Exchange, need not make duplicate reports to the Amex. Since none of these rules was violated by McDonnell & Co., the Amex argued, and the court below agreed, that the Amex could not be liable to the plaintiffs under

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centage ratio of aggregate indebtedness to net capital, establishes that the so-called "exception" language of the Exchange's rule 325 relates solely to the minimum dollar requirement and has nothing whatsoever to do with the maximum percentage ratio. Thus, Amex rule 446(a) requires a dollar figure for the net capital of a member firm carrying customer accounts of at least $50,000, but provides that the Amex may make a specific temporary exception to that minimum dollar figure due to unusual circumstances Amex rules 466 and 467 require that no member firm permit its ratio of aggregate indebtedness to net capital to exceed 2000% and provide that the Amex may, in the case of a particular member firm, prescribe greater requirements. Neither rule 466 nor rule 467 contains any language authorizing a specific temporary exception to its requirements. These Amex rules establish that the Exchange's rule 325 only permits an "exception" with respect to the minimum dollar amounts required for net capital. Nothing in the rules of either the Exchange or the Amex provides that the percentage net capital requirements may be made "easier." (The Amex rules, as in effect during all pertinent times referred to in the amended complaints, are plaintiffs' Exhibit 88 in evidence.)

* Amex rules 441, 442, 443, 444 and 445.

section 6 of the Exchange Act. The rules relied upon by the Amex are, however, totally irrelevant. The issue below was not whether McDonnell & Co. had failed to make a required financial report to the Amex. Rather, the issue was whether McDonnell & Co. had violated the Amex net capital rules.* The Amex net capital rules, unlike its ministerial reporting rules, do not exempt a dual member firm from compliance.

The court below incorrectly held that the Amex had successfully insulated itself from liability by delegating a series of ministerial functions to the Exchange. Enforcement of the net capital rules, drawn to insure financial stability of member firms and to protect investors, is among the primary obligations imposed upon the Amex pursuant to Section 6. The Amex, having elected to rely on the Exchange to properly discharge this protective role, is subject to liability for damages which result from the Exchange's failure to take appropriate action. *Cf.* Restatement (Second) of Agency, § 214 (1957). Thus, at the very least, the question of the Amex's liability presented a question of fact for the jury to be determined, under an appropriate instruction of law, in light of the jury's decision as to the propriety of the Exchange's regulatory response to the violations by McDonnell & Co. The court below improperly withdrew this question of fact from the jury, and, accordingly, a reversal is required.

CONCLUSION

For the reasons stated herein and in plaintiff-appellants' principal brief, the judgment of the district court should be reversed with a direction to enter judgment in favor of plaintiffs on their claims against the Exchange and the Amex or, in the alternative, to grant a new trial on said

* Amex rules 446, 466 and 467.

claims and with a further direction to grant a new trial on plaintiff Anna McDonnell's claims against McDonnell & Co.

Respectfully submitted,

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Dated: November 18, 1976.

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By [signature]

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